# MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

*You should read the following management's discussion in conjunction with our unaudited consolidated interim condensed financial information as of and for the three months ended 31 March, 2010. The consolidated interim condensed financial information has been prepared in accordance with International Accounting Standard 34 "Interim financial reporting" ("IAS 34"). This financial information should be read together with the consolidated financial statements for the year ended December 31, 2009, prepared in accordance with International Financial Reporting Standards ("IFRS").*

## OVERVIEW

We are one of the world's largest oil and gas companies in terms of reserves, production and market capitalization. Our revenues are primarily derived from sales of natural gas, crude oil and other hydrocarbon products to Western and Central Europe, Russia and other former Soviet Union countries.

We divide our operations into the following principal businesses:

- Production of gas – exploration and production of gas;
- Transport – transportation of gas;
- Distribution – sales of gas within Russian Federation and abroad;
- Gas storage – storage of extracted and purchased gas in underground gas storages;
- Production of crude oil and gas condensate – exploration and production of oil and gas condensate, sales of crude oil and gas condensate;
- Refining – processing of oil, gas condensate and other hydrocarbons, and sales of refined products; and
- Electric and heat energy generation and sales.

Other businesses primarily comprise production of other products and sales of several goods, works, services.

Our main business segments are mutually dependent, with a significant portion of the revenues of one segment comprising a part of the costs of another segment. In particular, our Distribution segment purchases natural gas from our Production of gas segment and transportation services from our Transport segment. Our Refining segment purchases gas from our Production of gas segment and crude oil and gas condensate from the Production of crude oil and gas condensate segment. We establish internal transfer prices with reference to the specific funding requirements of the individual subsidiaries within each segment. Accordingly, the results of operations of these segments on a stand-alone basis do not necessarily represent each segment's underlying financial position and results of operations as if it was a stand-alone business. For this reason, we do not analyze any of our main segments separately in the discussion that follows.

**RESULTS OF OPERATIONS**

(RR million)

| | Three months periods ended March 31, 2010 | 2009 |
|---|---|---|
| Sales | 956,816 | 837,156 |
| Net gain from trading activity | 5,964 | 3,339 |
| Operating expenses | (623,479) | (557,902) |
| **Operating profit** | **339,301** | **282,593** |
| Finance income | 71,502 | 119,014 |
| Finance expense | (18,965) | (268,438) |
| Share of net income of associated undertakings and jointly controlled entities | 28,229 | 13,536 |
| Gains on disposal of available-for-sale financial assets | 1,629 | 516 |
| **Profit before profit tax** | **421,696** | **147,221** |
| Current profit tax expense | (55,053) | (33,787) |
| Deferred profit tax expense | (29,794) | (3,257) |
| Profit tax expense | (84,847) | (37,044) |
| **Profit for the period** | **336,849** | **110,177** |
| | | |
| **Other comprehensive income** | | |
| | | |
| Gains arising from change in fair value of available-for-sale financial assets, net of tax | 9,793 | 1,740 |
| Share of other comprehensive income of associated undertakings and jointly controlled entities | 11 | 1,617 |
| Translation differences | (22,214) | 11,811 |
| **Other comprehensive (loss) income for the period, net of tax** | **(12,410)** | **15,168** |
| | | |
| **Total comprehensive income for the period** | **324,439** | **125,345** |
| | | |
| **Profit attributable to:** | | |
| owners of OAO Gazprom | 324,953 | 103,679 |
| non-controlling interest | 11,896 | 6,498 |
| | **336,849** | **110,177** |
| **Total comprehensive income attributable to:** | | |
| owners of OAO Gazprom | 314,630 | 119,135 |
| non-controlling interest | 9,809 | 6,210 |
| | **324,439** | **125,345** |

**Sales**

The following table sets out our volumes and realized prices for the three months periods ended March 31, 2010 and 2009.

| (RR million unless indicated otherwise) | Three months periods ended March 31, 2010 | 2009 |
|---|---|---|
| **Sales of gas** | | |
| *Europe and other countries* | | |
| Gross sales [1] | 365,952 | 414,638 |
| Excise tax | - | (290) |
| Customs duties | (79,734) | (48,012) |
| Net sales | 286,218 | 366,336 |
| Volumes in billion cubic meters (bcm) | 42.7 | 31.1 |
| Gross average price, U.S.$ per mcm[2] (including excise tax and customs duties) [3] | 286.8 | 392.3 |
| Gross average price, RR per mcm[2] (including excise tax and customs duties) | 8,572.9 | 13,311.6 |
| *FSU (Former Soviet Union)* | | |
| Gross sales (net of value added tax (VAT)) | 118,393 | 89,545 |
| Customs duties | (24,564) | (4,264) |
| Net sales | 93,829 | 85,281 |
| Volumes in bcm | 17.0 | 9.7 |
| Gross average price, U.S.$ per mcm [2] (including customs duties, net of VAT) [3] | 232.9 | 271.7 |
| Gross average price, RR per mcm [2] (including customs duties, net of VAT) | 6,961.4 | 9,219.3 |
| *Russian Federation* | | |
| Gross sales (net of VAT) | 232,783 | 157,947 |
| Net sales | 232,783 | 157,947 |
| Volumes in bcm | 102.5 | 93.2 |
| Gross average price, RR per mcm [2] (net of VAT) | 2,271.6 | 1,695.1 |
| *Total sales of gas* | | |
| Gross sales (net of VAT) | 717,128 | 662,130 |
| Excise tax | - | (290) |
| Customs duties | (104,298) | (52,276) |
| Net sales | 612,830 | 609,564 |
| Volumes in bcm | 162.2 | 134.0 |
| Net sales of refined products (net of excise tax, VAT and customs duties) | 153,545 | 97,804 |
| Net sales of electric and heat energy (net of VAT) | 95,416 | 59,607 |
| Net sales of crude oil and gas condensate (net of excise tax, VAT and customs duties) | 44,584 | 35,955 |
| Gas transportation net sales (net of VAT) | 25,147 | 12,825 |
| Other revenues (net of VAT) | 25,294 | 21,401 |
| **Total sales (net of excise tax, VAT and customs duties)** | **956,816** | **837,156** |

Notes:

[1] VAT is not charged on sales to Europe and other countries.

[2] One mcm is equivalent to 35,316 cubic feet.

[3] Calculated on the basis of average rate.

Total sales (net of excise tax, VAT and customs duties) increased by RR 119,660 million, or 14%, to RR 956,816 million in the three months period ended March 31, 2010 compared to the same period of the prior year.

Net sales of gas accounted for 64% and 73% of total net sales in the three months periods ended March 31, 2010 and 2009, respectively.

Net sales of gas increased from RR 609,564 million in the three months period ended March 31, 2009 to RR 612,830 million in the three months period ended March 31, 2010 or by 1%.

Net sales of gas to Europe and other countries decreased in the three months period ended March 31, 2010 compared to the three months period ended March 31, 2009, by RR 80,118 million, or 22%, to RR 286,218 million. The overall decrease in net sales of gas to Europe and other countries was primarily driven by decrease in average prices.

The gross average RR price (including excise tax and customs duties) decreased by 36% for the three months period ended March 31, 2010, compared to the three months period ended March 31, 2009. At the same time volume of gas sold for the three months period ended March 31, 2010 increased by 37% compared to the same period of the prior year.

Net sales of gas to FSU countries increased in the three months period ended March 31, 2010 compared to the three months period ended March 31, 2009, by RR 8,548 million, or 10%, to RR 93,829 million. This increase was mainly due to increase in volumes of gas sold to FSU countries by 75% in the three months period ended March 31, 2010 compared to the three months period ended March 31, 2009. At the same time the gross average RR price (including customs duties, net of VAT) decreased by 24% in the three months period ended March 31, 2010 compared to the same period of the prior year.

Net sales of gas in the domestic market increased in the three months period ended March 31, 2010 compared to the same period of the prior year, by RR 74,836 million, or 47%, to RR 232,783 million. This increase was due to the increase in the gross average price for domestic gas sales by 34% in the three months period ended March 31, 2010 compared to the same period of the prior year due to increase in tariffs which are set by the Federal Tariffs Service (FTS), and increase in the volumes of gas sold by 10% in the three months period ended March 31, 2010 compared to the same period of the prior year.

Net sales of refined products (net of excise tax, VAT and customs duties) increased by RR 55,741 million, or 57%, to RR 153,545 million in the three months period ended March 31, 2010 in comparison with the same period of the prior year. The increase mainly resulted from the increase of world prices for refined products and increase in volumes sold in the three months period ended March 31, 2010 compared to the same period of the prior year. In the three months periods ended March 31, 2010 and 2009 Gazprom neft Group’s sales comprised 82% and 86% of the total amount of our net sales of refined products, respectively.

Net sales of electric and heat energy (net of VAT) increased by RR 35,809 million, or 60% to RR 95,416 in the three months period ended March 31, 2010 compared to the same period of the prior year. This increase was mainly due to consolidation of TGC-1 starting from December 31, 2009 and increase of sales of electric and heat energy related to activity of Mosenergo, WGC-2 and WGC-6 by RR 17,318 million, or 32%.

Net sales of crude oil and gas condensate (net of excise tax, VAT and customs duties) increased by RR 8,629 million, or 24%, to RR 44,584 million in the three months period ended March 31, 2010 compared to RR 35,955 million in the three months period ended March 31, 2009. The increase was mainly caused by the increase of oil price in the three months period ended March 31, 2010 compared to the same period of the prior year. Also the increase was supported by the increase of the volume of gas condensate sold in the three months period ended March 31, 2010 compared to the same period of the prior year. Sales of crude oil included in net sales of crude oil and gas condensate (net of excise tax, VAT and customs duties), amounted to RR 38,503 million and RR 33,705 million in the three months periods ended March 31, 2010 and 2009, respectively.

Gas transportation net sales (net of VAT) increased by RR 12,322 million, or 96%, to RR 25,147 million in the three months period ended March 31, 2010 from RR 12,825 million in the three months period ended March 31, 2009. The increase was mainly caused by increased gas volumes transported for independent gas suppliers during the three months period ended March 31, 2010 compared to the same period of the prior year.

Other revenues increased by RR 3,893 million, or 18%, to RR 25,294 million in the three months period ended March 31, 2010 compared to RR 21,401 million in the three months period ended March 31, 2009.

**Operating expenses**

Operating expenses increased by 12% in the three months period ended March 31, 2010 to RR 623,479 million from RR 557,902 million in the three months period ended March 31, 2009. Operating expenses as a percentage of sales decreased from 67% in the three months period ended March 31, 2009 to 65% in the three months period ended March 31, 2010. The table below presents a breakdown of operating expenses in each period:

| (RR million) | Three months periods ended 31 March, 2010 | 2009 |
|---|---|---|
| Purchased gas and oil | 138,536 | 239,588 |
| Staff costs | 82,764 | 59,653 |
| Transit of gas, oil and refined products | 76,360 | 62,833 |
| Taxes other than on income | 74,985 | 49,886 |
| Depreciation | 68,014 | 54,480 |
| Repairs and maintenance | 27,412 | 23,745 |
| Materials | 21,642 | 14,562 |
| Exchange rate differences on operating items | 20,760 | (52,591) |
| Electricity and heating expenses | 18,966 | 10,539 |
| Cost of goods for resale, including refined products | 11,816 | 23,854 |
| Rental expenses | 5,976 | 3,695 |
| Social expenses | 5,303 | 4,182 |
| Insurance expenses | 4,578 | 3,697 |
| Charge for impairment provisions | 4,242 | 6,024 |
| Other | 62,125 | 53,755 |
| **Total operating expenses** | **623,479** | **557,902** |

*Purchased gas and oil*

Cost of purchased gas and oil decreased by 42% to RR 138,536 million in the three months period ended March 31, 2010 from RR 239,588 million in the three months period ended March 31, 2009. The decrease in cost of purchased gas primarily relates to the decrease of expenses on gas purchased from Central Asian suppliers. The cost of purchased oil included in the cost of purchased gas and oil increased by RR 24,332 million, or 109%, and amounted to RR 46,688 million in the three months period ended March 31, 2010 in comparison with RR 22,356 million in the three months period ended March 31, 2009 due to increase in oil prices and increase in volumes of purchased oil.

*Staff costs*

Staff costs increased by 39% to RR 82,764 million in the three months period ended March 31, 2010 from RR 59,653 million in the three months period ended March 31, 2009. The increase resulted from the salary indexation. The increase also reflects the consolidation of TGC-1 starting from the fourth quarter of 2009 and acquisitions of new subsidiaries by the Gazprom neft Group.

*Transit of gas, oil and refined products*

Transit of gas, oil and refined products increased by 22% to RR 76,360 million in the three months period ended March 31, 2010 from RR 62,833 million in the three months period ended March 31, 2009. This increase mainly relates to increased costs of transportation through Ukraine.

*Taxes other than on income*

Taxes other than on income consist of:

| (RR million) | Three months periods ended March 31, 2010 | 2009 |
|---|---|---|
| Natural resources production tax | 47,464 | 27,964 |
| Property tax | 10,718 | 7,978 |
| Other taxes | 16,803 | 13,944 |
| **Taxes other than on income** | **74,985** | **49,886** |

The natural resources production tax increased by 70% to RR 47,464 million in the three months period ended March 31, 2010 from RR 27,964 million in the three months period ended March 31, 2009. The increase mainly resulted from increase of natural resources production tax rate due to increase in average world oil prices as well from a general increase of gas production.

*Depreciation*

Depreciation increased by 25% or RR 13,534 million to RR 68,014 million in the three months period ended March 31, 2010 from RR 54,480 million in the three months period ended March 31, 2009. The increase primary relates to the growth in fixed asset base.

*Repairs and maintenance*

Cost of repairs and maintenance increased by 15% to RR 27,412 million in three months period ended March 31, 2010 from RR 23,745 million in the three months period ended March 31, 2009. This increase was caused by increase of volume of repair services rendered by third parties to the Group in the first quarter of 2010.

*Materials*

Cost of materials increased by 49% to RR 21,642 million in the three months period ended March 31, 2010 from RR 14,562 million in the three months period ended March 31, 2009. The increase mainly resulted from the increase of expenses on fuel in the segment “Electric and heat energy generation and sales”.

*Exchange rate differences on operating items*

Exchange rate differences on operating items in the three months ended March 31, 2010 amounted to a net loss of RR 20,760 million in comparison with exchange rate differences on operating items in the amount of a net gain of RR 52,591 million in the same period of the prior year. The change was primary driven by appreciation of RUR against USD and EUR by 3% and 8%, respectively, in the three months ended March 31, 2010, compared to depreciation of RUR against USD and EUR by 16% and 8%, respectively, in the same period of the prior year.

*Electricity and heating expenses*

Electricity and heating expenses increased by 80% to RR 18,966 million in the three months period ended March 31, 2010 from RR 10,539 million in the three months period ended March 31, 2009. The increase mainly resulted from the increase of electricity consumption.

*Cost of goods for resale, including refined products*

Cost of goods for resale, including refined products decreased by 50% to RR 11,816 million in the three months period ended March 31, 2010 from RR 23,854 million in the three months period ended March 31, 2009. The decrease in cost of goods for resale, including refined products, mainly results from decrease in volumes of purchased refined products performed by the Gazprom neft Group.

*Other operating expenses*

Other operating expenses increased by 16% to RR 62,125 million in the three months period ended March 31, 2010 from RR 53,755 million in the three months period ended March 31, 2009. Other operating expenses include research and development expenses, refining services, transportation expenses, heat energy transmission expenses, bank charges, security services, legal and consulting services, charity and financial aid, and advertising.

**Operating profit**

As a result of the factors discussed above, our operating profit increased by RR 56,708 million, or 20%, to RR 339,301 million in the three months period ended March 31, 2010 from RR 282,593 million in the same period of the prior year. Our operating profit margin increased from 34% in the three months period ended March 31, 2009 to 35% in the three months period ended March 31, 2010.

**Finance income (expense)**

| (RR million) | Three months periods ended March 31, 2010 | 2009 |
|---|---|---|
| Exchange gains | 63,940 | 115,027 |
| Exchange losses | (4,686) | (255,397) |
| Net exchange gain (loss) | 59,254 | (140,370) |
| Interest income | 7,560 | 3,951 |
| Interest expense | (14,279) | (13,041) |
| Gains on extinguishment of restructured liabilities | 2 | 36 |
| **Net finance income (expense)** | **52,537** | **(149,424)** |

Exchange gains decreased by RR 51,087 million to RR 63,940 million in the three months period ended March 31, 2010, compared to RR 115,027 million in the three months period ended March 31, 2009. Exchange losses decreased by RR 250,711 million to RR 4,686 million in the three months period ended March 31, 2010 from RR 255,397 million in the three months period ended March 31, 2009. The decrease in exchange gains and exchange losses resulted from lower fluctuation of USD and EURO exchange rates against RR in the three months ended March 31, 2010 in comparison with the same period of the prior year.

Interest income increased by 91% to RR 7,560 million in the three months period ended March 31, 2010 from RR 3,951 million in the three months period ended March 31, 2009, mainly due to increase in loans issued during 2009 and in the three months period ended March 31, 2010.

Interest expense increased by 9% to RR 14,279 million in the three months period ended March 31, 2010 from RR 13,041 million in the three months period ended March 31, 2009, mainly due to increase of average borrowings balance during three months period ended March 31, 2010, in comparison with the same period of the prior year.

**Share of net income of associated undertakings and jointly controlled entities**

Share of net income of associated undertakings and jointly controlled entities increased by RR 14,693 million, or 109%, to RR 28,229 million in the three months ended March 31, 2010 compared to RR 13,536 million in the same period of the prior year. The increase of the Group's share of net income of associated undertakings and jointly controlled entities in the three months ended March 31, 2010 relates mainly to increase of net income of Sakhalin Energy Investment Company Ltd. due to the start of liquefied natural gas production in March 2009 and increase of net income of Gazprombank Group as a result of improved performance of banking and petrochemical businesses in the three months period ended March 31, 2010 compared to the same period of the prior year.

**Profit tax**

Total profit tax expense increased by RR 47,803 million, or 129%, to RR 84,847 million in the three months period ended March 31, 2010 compared to RR 37,044 million in the three months period ended March 31, 2009. The effective profit tax rate was 20.1% and 25.2% in the three months periods ended March 31, 2010 and 2009, respectively. Change of the effective profit tax rate mainly resulted from a relative decrease of non-deductable expenses and increase of non-taxable share of net income of associated undertakings and jointly controlled entities in the three months period ended March 31, 2010 compared to the same period of the prior year.

**Profit for the period attributable to owners of OAO Gazprom**

As a result of the factors discussed above, our profit for the period attributable to owners of OAO Gazprom increased by RR 221,274 million or 213%, from RR 103,679 million in the three months period ended March 31, 2009 to RR 324,953 million in the three months period ended March 31, 2010.

**Profit for the period attributable to non-controlling interest**

Profit for the period attributable to non-controlling interest increased by RR 5,398 million or 83% to RR 11,896 million in the three months period ended March 31, 2010 compared to RR 6,498 million in the three months period ended March 31, 2009.

## LIQUIDITY AND CAPITAL RESOURCES

The following table summarizes our statements of cash flows for the three months ended March 31, 2010 and 2009:

| | Three months periods ended March 31, | |
|---|---|---|
| (RR million) | 2010 | 2009 |
| Net cash provided by operating activities | 483,116 | 233,963 |
| Net cash used for investing activities | (250,061) | (236,071) |
| Net cash used for financing activities | (48,882) | (16,249) |

*Net cash provided by operating activities*

Net cash provided by operating activities amounted to RR 483,116 million in the three months period ended March 31, 2010 compared to RR 233,963 million in the three months period ended March 31, 2009. The increase was primarily due to growth of our operating profit in the three months period ended March 31, 2010 in comparison with the same period of the prior year, which was supplemented by positive dynamics of changes in working capital.

*Net cash used for investing activities*

Net cash used for investing activities increased by RR 13,990 million, or 6%, to RR 250,061 million in the three months period ended March 31, 2010 compared to RR 236,071 million in the three months period ended March 31, 2009. In a context of increase in total capital expenditures the increase of net cash used for investing activities was also due to second installment paid in March 2010 for the acquisition of controlling interest in SeverEnergiya in the amount of RR 34,715 million. These effects were partly offset by receipt of proceeds from redemption of preference shares by Sakhalin Energy Investment Company Ltd. in the amount of RR 9,910 million.

*Net cash used for financing activities*

Net cash used for financing activities amounted to RR 48,882 million in the three months period ended March 31, 2010 compared to RR 16,249 million in the three months period ended March 31, 2009. This change was due to decrease in proceeds from long-term borrowings in the three months period ended March 31, 2010 compared to the same period of the prior year.

## CAPITAL EXPENDITURES

Total capital expenditures (excluding the effect of acquisitions of subsidiaries) by segment for the three months periods ended March 31, 2010 and 2009 in nominal RR terms, amounted to the following:

| | Three months periods ended March 31, | |
|---|---|---|
| | 2010 | 2009 |
| (RR million) | | |
| Transport | 78,771 | 62,223 |
| Production of gas | 58,947 | 52,987 |
| Production of crude oil and gas condensate | 18,510 | 15,805 |
| Refining | 10,063 | 7,924 |
| Distribution | 7,737 | 9,110 |
| Electric and heat energy generation and sales | 7,229 | 2,994 |
| Gas storage | 1,409 | 1,489 |
| All other segments | 4,129 | 2,863 |
| **Total** | **186,795** | **155,395** |

Total capital expenditures (excluding the effect of acquisitions of subsidiaries) increased by RR 31,400 million, or 20%, from RR 155,395 million in the three months period ended March 31, 2009 to RR 186,795 million in the three months period ended March 31, 2010. The increase of our capital expenditures in the Production of gas segment was primarily due to increased capital expenditure on the construction of new wells and railway Obskaya – Bovanenkovo at Bovanenkovskoye field and construction of semisubmersible drilling platform at Shtokman field. The increase of our capital expenditures in the Transportation segment was primarily due to increased capital expenditure on the construction of major transportation projects, including Bovanenkovo-Uhta, Nord Stream and Pochinki-Gryazovets. The increase of capital expenditures in the Electric and heat energy generation and sales segment is mainly attributed to consolidation of TGC-1 starting from December 31, 2009.

## DEBT OBLIGATIONS

Net debt balance (defined as the sum of short-term borrowings, current portion of long-term borrowings, short-term promissory notes payable, long-term borrowings, long-term promissory notes payable and restructured tax liabilities, net of cash and cash equivalents and balances of cash and cash equivalents restricted as to withdrawal under the terms of certain borrowings and other contractual obligations) decreased by RR 395,041 million, or 29%, from RR 1,372,307 million as of December 31, 2009 to RR 977,266 million as of March 31, 2010. This decrease resulted from increase of cash and cash equivalents and decrease of short-term and long-term borrowings, which was primarily caused by the effect of classification of borrowings of ZAO Gazenergoprombank as liabilities of disposal group held for sale as of March 31, 2010.